

# The Case for Tipping and Unrestricted Tip-Pooling: Promoting Intrafirm Cooperation

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*Going against the well-established tipping norm in the United States, a growing number of restaurant owners are moving to ban tipping, and instead raise prices, in their restaurants. They argue that existing law precludes them from sharing tips with “back-of-the-house” employees (like chefs and dishwashers), and thus makes it hard to compensate those employees fairly for their contribution to the joint endeavor. We argue that the movement against tipping is ill-advised. Tipping is a valuable social institution that allows customers to monitor service where management cannot. The better answer to a flat out tipping ban is to remove legal restrictions on tip-pooling. Pooling tips among a broad swath of employees (other than ownership-level employees) is in keeping with the cooperative effort that underlies the provision of service in settings like restaurants. Managers thus can deploy tip-pooling to allow the compensation scheme to promote cooperation among workers in the joint endeavor of service provision.*

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We discuss in this Essay (1) the relative merits of a no-tipping policy vs. a tipping policy for employers in settings where customers customarily tip employees, and (2) the relative merits of a policy barring the sharing of tips with other non-owner employees vs. a policy allowing (or requiring) tip-pooling in these settings. We do not here discuss other important questions concerning tipping, such as whether there should be a subminimum wage for “tipped” employees and if so, whether that wage floor should be raised in light of increases in the cost of living or minimum wages. See NATIONAL EMPLOYMENT COUNCIL ET AL., THE IMPACT OF RAISING THE MINIMUM WAGE ON WOMEN 5 ff. (March 2014); SYLVIA A. ALLEGRETO & DAVID COOPER, TWENTY-THREE YEARS AND STILL WAITING FOR CHANGE: WHY IT’S TIME TO GIVE TIPPED WORKERS THE REGULAR MINIMUM WAGE (Economic Policy Institute & CWED, University of Calif., Berkeley, July 10, 2014).

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## INTRODUCTION

Tipping practices, and attitudes towards tipping, have shifted over time. Imported from Europe, tipping grew in popularity across the country’s first century;<sup>1</sup> by the early 1900s, the tipping norm was well-established.<sup>2</sup> Then, in an about-face, the first half of the twentieth century witnessed growing discomfort with the practice,<sup>3</sup> extending even to the organization of an “Anti-Tipping Society of America.”<sup>4</sup> Some establishments actively discouraged tipping.<sup>5</sup> The anti-

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<sup>1</sup> See KERRY SEGRAVE, *TIPPING: AN AMERICAN SOCIAL HISTORY OF GRATUITIES* 1-6 (1998).

<sup>2</sup> See *id.* at 7.

<sup>3</sup> See *id.* at 9-24.

<sup>4</sup> Members of the Anti-Tipping Society of America were required not to give a tip to anyone for 12 months, “and to meet possible resultant embarrassment each member is supplied with membership cards which he hands over to such neighbors as may be about him and endeavors to enlist them in the organization.” Commercial travelers and businessmen were the principal members of this group, which claimed to have a membership of 100,000 by 1905. *Id.* at 28-29.

<sup>5</sup> See *id.* at 16-17 (noting that the New York Central Railroad actively sought to discourage customers from tipping redcaps, on the ground that the company paid the redcaps directly); *The Petrified Forest* (a 1936 film that featured a scene in a diner with a sign, “Tipping isn’t American Keep your change,” prominently hanging behind the counter).

tipping movement eventually lost momentum,<sup>6</sup> however, and tipping became fairly entrenched in American life and culture, at least in restaurants and hotels in big cities.<sup>7</sup> Since tipping traditionally has been seen as a reward for quality service, fast-food restaurants typically were not settings where tipping occurred; today, however, numerous fast-food establishments feature “tip jars.”<sup>8</sup>

Recently, however, opposition to tipping has re-emerged. A growing number of restaurants have announced their intention to eliminate tipping.<sup>9</sup> It is not always clear what these restaurateurs are in fact planning to do. Some intend to pay all servers at least the statutory minimum and perhaps dissuade diners from leaving tips. In its place, the restaurant would impose a service charge presumably to cover lost tip income to the employees. Others may simply raise server pay to the minimum wage but without discouraging customer tipping. By paying the minimum wage, the restaurant no longer claims a “tip credit” on its tax returns; rather the full extent of wages and other labor costs are posted against income.

Perhaps the most notable example of the emergent no-tipping trend is the decision by New York City’s Union Square Hospitality Group (“USHG”)—the owner and operator of several popular New York eateries headed by celebrity restaurateur Danny Meyer—to eliminate tipping at its establishments by the end of 2016.<sup>10</sup> USHG has already “prohibited” tipping at one of its restaurants and

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<sup>6</sup> See SEGRAVE, *supra* note 1, at 59 (“In response to tipping practices in 1920-1949, hotels and restaurants which did not allow tips continued to exist, but in very small numbers.”); *id.* at 93 (“Establishments with a no-tip policy that did not substitute an added service charger were rare in America” during the 1950s and 1960s.).

<sup>7</sup> See, e.g., SYLVIA PLATH, *THE BELL JAR* (1963) (recounting character’s difficulties in deciding whether and how much to tip); “Affirmative Action”, *Curb Your Enthusiasm* (2000) (problems arise when trying to tip a pharmacist for faster service); “Opening Night”, *Curb Your Enthusiasm* (2004) (commentary on the frequency of tipping); “Reunion”, *Curb Your Enthusiasm* (2009) (addressing the tipping difficulties that arise when two members of a party order the same thing and get separate checks); “Black Swan”, *Curb Your Enthusiasm* (2009) (critiquing additional tips on top of mandatory service charges).

<sup>8</sup> Tipping generally occurs in restaurants, hotels, hair and nail salons, and similar service establishments. It is also a significant practice in the gaming industry. See generally Kandis McClure, *Tip-Pooling at Nevada Casinos*, 5 UNLV GAMING L.J. 81 (2014).

<sup>9</sup> See Patricia Cohen, *Restaurants Say No to Tips, Yes to Higher Prices*, N.Y. TIMES, Aug. 24, 2015, at A1; Pete Wells, *Tips Are Going Away at a Prominent Restaurant Group*, N.Y. TIMES, Oct. 15, 2015, at A24; Sophia Hollander, *Behind the Move to Ban Tipping*, WALL ST. J., Nov. 10, 2015.

<sup>10</sup> See Wells, *supra* note 9 (“In a sweeping change to how most of its 1,800 employees are paid, the Union Square Hospitality Group will eliminate tipping at Gramercy Tavern, Union Square Cafe and its 11 other restaurants by the end of next year, the company’s chief executive, Danny Meyer, said . . .”); Jeff Gordinier, *No Tipping, the Danny Meyer Way*, N.Y. TIMES, Nov. 18, 2015, at D8.

increased menu prices<sup>11</sup> in order to be able to afford higher (non-tipped-based) wages for employees.<sup>12</sup>

Restaurateurs offer different of justifications for their no-tipping position.<sup>13</sup> It seems unclear what is driving the movement but a predominant theme appears to be a desire to implement a more equitable sharing of tip income so that it is not exclusively for the benefit of “front-of-the-house” workers such as waiters—who typically come in contact with customers—but can also be shared with “back-of-the-house” employees, such as the people in the kitchen—who do not. Federal and state laws presently constrain such tip-sharing arrangements.

There is bit of disconnect here because if the perceived “evil” are undue restrictions on tip-pooling, it is unclear how a ban on tipping solves the problem. Unless the customer perception is that no server needs supplemental income from tipping because the server is paid an adequate fixed salary, customers will still tip to some extent and the issue will arise whether the tips belong only to the server or whether they may be shared with other employees who contribute to the collective endeavor.

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<sup>11</sup> See Gordinier, *supra* note 10 (“Lobster sausage, now selling for \$33, will cost \$44. The king crab fritters with avocado and lime are \$17, and are going up to \$18.”).

<sup>12</sup> Cf. Gordinier, *supra* note 10 (“Will . . . servers make as much money as they normally would from tips on a wildly busy Saturday night? That remains to be seen, but at least into February, the company is promising to match the average wage by position from the same time last year.”).

<sup>13</sup> See Cohen *supra* note 9 (listing as justifications various restaurateurs and managers offered for considering the elimination of tipping (i) the growth of the minimum wage (especially in particular states and localities), which forces ownership to give raises to workers who are already receiving amounts far in excess of the minimum wage in tip income, (ii) avoiding the “confusing welter of federal, state and local regulations and tax laws” that govern tipping, (iii) gaining the freedom “to better calibrate wages to reward employees based on the length of their service and the complexity of their jobs,” and (iv) concern over “research showing that diners tend to tip black servers less and that the system can encourage sexual harassment of women”); Wells, *supra* note 9, (listing as justifications various restaurateurs and managers offered for considering the elimination of tipping (i) the “belie[f] [that] it is unfair for servers’ pay to be affected by their race and age, their customer’s moods, the weather and other factors that have nothing to do with performance, (ii) a “rash of class-action lawsuits over tipping irregularities, many of which have been settled for millions of dollars,” and (iii) the belief that “customers would enjoy leaving the table without having to solve a math problem”); Hollander *supra* note 9 (reporting that one restaurateur eliminated tipping “to make his waiters’ compensation more stable”); Harriet Alexander, *New Yorkers Bemused by New No-Tipping Policy in Michelin-Starred Manhattan Restaurant*, *The Telegraph*, Nov. 22, 2015 (““It’s troubled me for 21 years that the tipping system is antithetical to creating a real profession for people who takes their jobs seriously,” [Danny Meyer] said. ‘You don’t tip your doctor if they do a good job. You don’t tip the airline pilot if the plane lands. It’s actually a demeaning practice.’”).

In the restaurant setting, tip-pooling occurs when tips received by one employee are shared by other employees. For example, waiters at a restaurant might share jointly all the tips (or some portion of the tips) they receive. A broader arrangement might have those tips being shared beyond the waitstaff, among those who bus the tables. Tip-pooling is a mechanism for promoting cooperation among the employees who contribute to the collective endeavor who otherwise might be engaged in wasteful competition for tables and customers.

As waiters and bussers come into regular contact with customers, they are, in the vernacular of restaurants, “front-of-the-house” employees. Some employers—USHG being one—would like to have tip-pooling arrangements that include not just front-of-house employees but also “back of the house” employees who do *not* come in regular contact with employees, such as chefs and other kitchen staff. Such tip-pooling arrangements would allow employers to spread income across restaurant employees.

Existing legal rules make it difficult for the employer to adopt what the employer believes is the optimal tip-pooling arrangement for its employees. Under federal law, if the employer wishes to receive a “tip credit” – to have some of the sums received by employees in tips count toward the statutory minimum wage, the sharing of tips is limited to employees “who customarily and regularly receive tips”.<sup>14</sup> Management-level employees, including team captains and maître d’s, are excluded, as are back-of-the-house staff such as the employees in the kitchen.

It is not clear, even under federal law, whether an employer that intends to pay all of its employees the statutory minimum wage, and thus will not be taking a tip credit, may institute a tip-pooling arrangement that allows participation by employees who do not “customarily and regularly” receive tips. The U.S. Department of Labor (“DOL”), which enforces the federal Fair Labor Standards Act, has since 1989<sup>15</sup> taken the position that the restriction on pooling stands whether or not a tip credit is claimed.<sup>16</sup> But in *Cumbie v. Wendy Woo II, Inc.*,<sup>17</sup> a

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<sup>14</sup> 29 U.S.C. § 203(m); see 29 C.F.R. § 531.59 (“[A]ll tips received by the tipped employee must be retained by the employee except for a valid tip pooling arrangement limited to employees who customarily and regularly receive tips . . .”).

<sup>15</sup> The agency’s pre-1989 view was that restrictions on tip pooling applied only where the employer sought to claim the tip credit. See U.S. Dep’t of Labor, Wage & Hour Div. Op. Ltr. No. WH-251 (Dec. 26, 1973).

<sup>16</sup> See U.S. Dep’t of Labor, Wage & Hour Div. Op. Ltr. No. WH-536 (Oct. 26, 1989) (“Although section 3(m) concerns the circumstances in which a tip credit can be taken, it also provides guidance on the circumstances in which a requirement that employers contribute a portion of their tips to other employees would be an improper deduction from wages for purposes of compliance with section 6 of the Act.”). DOL reasoned that a tip pool that includes employees who do not customarily and regularly receive tips would violate the minimum wage provision (notwithstanding whether the employer laid claim to the tip credit) if the employee were not reimbursed for the full amount contributed to the pool on top of the minimum wage, because “the employer would, in effect, contribute part

2010 decision, the Ninth Circuit held that the FLSA tip-pooling limitation applies only where employers also invoke the tip credit to pay their employees less than the minimum wage.<sup>18</sup> In April 2011, the DOL issued regulations reaffirming its tip-pooling restriction.<sup>19</sup> In February 2016, a panel of the Ninth Circuit in *Oregon Restaurant & Lodging Association v. Perez* held that its decision in *Cumbie* did not preclude the DOL from issuing its 2011 regulation, and upheld that regulation as within the agency's discretion.<sup>20</sup>

In this Essay, we present the case for tipping and relatively unrestricted tip-pooling among employees. We offer two claims. First, tipping is a valuable economic practice that can benefit both employees and owners. Tipping helps to solve a principal-agent problem between management and workers. When customers tip based upon the quantity and quality of service, they provide an important feedback mechanism on employee performance in circumstances where the employer cannot readily monitor that performance. Tipping facilitates "buyer monitoring."<sup>21</sup> Tip income on average will be a function of customer satisfaction. Employees unhappy with their tips will improve their performance or change jobs.<sup>22</sup> In addition, although this may not provide a complete public-policy justification, in settings where cash tips prevail, tipping allows customers (and therefore, if indirectly, employers) more cheaply to reimburse employees for their services.<sup>23</sup> Since cash tips are less likely to be taxed (or at least are likely to be under-taxed), the actual benefit to employees is greater than the same amount in

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of the his or her property to the employer or to other persons for the benefit of the employer, with the result that the employee would not have received the full minimum wage 'free and clear.'" *Id.*

<sup>17</sup> 596 F.3d 577 (9th Cir. 2010).

<sup>18</sup> *See id.* at 579-83.

<sup>19</sup> 78 Fed. Reg. 19, 832 (Apr. 5, 2011). *See* Memorandum from Nancy Leppink, Deputy Adm'r, U.S. Dep't of Labor to Reg'l Adm'rs & Dist. Dirs., Field Assistance Bulletin No. 2012-2: Enforcement of 2011 Tip Credit Regulations (Feb. 29, 2012).

<sup>19</sup> As will be seen, we take issue with the general claims of our colleague Yoram Margalioth. *See infra* note 63.

<sup>20</sup> \_\_\_ F.3d \_\_\_, 2016 WL 706678 (9th Cir. Feb. 23, 2016).

<sup>21</sup> *See* Robert J. Kwortnick, Jr., W. Michael Lynn & William T. Ross, Jr., *Buyer Monitoring: A Means to Insure Personalized Service*, 46 J. MARKETING RES. 573 (Oct. 2009).

<sup>22</sup> The empirical literature suggests, however, that tip income is not always related to customer service. *See* Michael Lynn, *Tip Levels and Service: An Update, Extension, and Reconciliation*, CORNELL HOTEL & REST. Q. 139 (Oct.-Nov.2003); Michael Lynn, *Restaurant Tipping and Service Quality*, CORNELL HOTEL & REST. Q. 14 (Feb. 2001). Based on this literature, one commentator urges that tipping provides no monitoring, and hence no social, benefits. *See* Yoram Margalioth, *The Social Norm of Tipping, Its Correlation with Inequality, and Differences in Tax Treatment Across Countries*, 11 THEORETICAL INQ. IN LAW 561 (2010).

<sup>23</sup> *See* Samuel Estreicher & Jonathan R. Nash, *The Law and Economics of Tipping: The Laborer's Perspective* (2006), available at <http://law.bepress.com/cgi/viewcontent.cgi?article=1068&context=alea>.

(taxable) income would be. In a sense, cash tips allow the customer to distribute income from the public fisc to the direct provider of services

Our second claim is that tip-pooling generally is a generally desirable practice because it promotes cooperation among employees towards achieving the goals of the enterprise, and that most legal restrictions on tip-pooling are ill-advised. Serving customers is often a cooperative endeavor among numerous employees. Tip-pooling arrangements provide an opportunity for those employees to structure their work efficiently. Legal restrictions on tip-pooling preclude employees from putting in place arrangements which would further the shared objectives of all the employees. These legal restrictions further may fuel friction among employees, only some of whom are legally eligible to participate in tip-pooling. While we agree that ownership-level management should be precluded from participating in tip-pooling (lest they be encouraged to exercise to power over non-management employees to force their way into the tip pool), but other restrictions on tip-pooling arrangements are generally undesirable.

Not *all* restrictions on tip-pooling should be eliminated. In particular, we believe that the barrier against allowing owners to share in tip proceeds should remain robustly in place. There are at least two reasons for retaining this ban. First, for the same reason that we believe management ought to have greater freedom in mandating tip-pooling arrangements, ownership-level employees ought not to be allowed to participate in those arrangements. Ownership puts its capital at risk in running the business and enjoys the profit upside. As such, they already have a monetary incentive to provide good service.<sup>24</sup> Thus, they should have no claim to customers' tips, moneys that are designed to reward non-management employees for providing quality service. Second, allowing management-level employees to participate in those tip pools would create an almost irresistible incentive for management to raid tip income. Even if some degree of tip-sharing among some management-level employees might be economically efficient, the incentive would be to raid tip income would dominate any beneficial effects.

This Essay proceeds as follows. Part II presents doctrinal background. It discusses the laws governing tip-pooling, with an emphasis on the relevant federal and state laws. Part III analyzes, from a law-and-economics perspective, how tip-pooling arrangements—both voluntary and mandatory—might arise, and what form they might take. Part IV elucidates how governing law limits the freedom of restaurateurs who wish to put tip-pooling arrangements in place, and the incentives that these limits on tip-pooling ensconce. It also analyzes the response

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<sup>24</sup> It is at least in part for this reason that, even in establishments where tipping is otherwise customary, the tipping norm does not generally extend to owners who are personally providing the service. See, e.g., Saul Levmore, *Commissions and Conflicts in Agency Arrangements: Lawyers, Real Estate Brokers, Underwriters, and Other Agents' Rewards*, 36 J.L. & ECON. 503, 533 n.55 (1993).

of USHG and explains how the response falls short. Part IV suggests revisions to existing law that would free up management’s freedom to rely on tip-pooling.

## I. LEGAL TREATMENT OF TIP-POOLING

In this Part, we provide an overview of the legal treatment of tip-pooling. Section A discusses governing federal law; Section B presents a summary of applicable state laws.

### A. Federal Law

Before we move on to the specifics of federal regulation of tip-pooling, we discuss how and when federal law empowers employers to take advantage of the “tip credit,” and pay less than minimum wage to employees on the assumption that tip income will bring the employees’ actual total wages up to—and possibly beyond—the minimum wage. We discuss the “tip credit” first, both because the tip credit provides an incentive for employers to institute tip-pooling arrangements in place in order to bring more employees within tip-credit rubric, and also because (as we shall see) the extent to which an employer is free allowance to mandate a tip-pooling arrangement may depend upon whether the employer seeks to invoke the tip credit.

#### 1. Tip Credit

The “tip credit” is an exception to the federal minimum wage law. While the Fair Labor Standards Act (“FLSA”)<sup>25</sup> establishes a national minimum wage,<sup>26</sup> the statute sets out a slightly modified standard for so-called “tipped employees”—that is, employees “engaged in an occupation in which [they] customarily and regularly receive[] more than \$30 a month in tips.”<sup>27</sup> While tipped employees must receive at least the minimum wage, they may receive a portion of their compensation in the form of tips rather than direct cash wages: The 1966 amendments to the FLSA allowed employers to take a tip credit for up to 50 percent of the statutory minimum wage..<sup>28</sup> In 1996, Congress amended the law to remove the percentage limitation and tie the minimum-wage obligation to a fixed amount.<sup>29</sup> Current law sets the minimum compensation cash compensation

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<sup>25</sup> 29 U.S.C. §§ 201-219.

<sup>26</sup> *See id.* § 206(a)(1). Since 1997, the minimum wage has been set at \$5.15 per hour. The FLSA sets only a federal minimum wage floor; it explicitly authorizes state and local governments free to impose higher minimum wage requirements. *Id.* § 218(a).

<sup>27</sup> *Id.* § 203(t).

<sup>28</sup> *See* Susan N. Eisenberg & Jennifer T. Williams, *Evolution of Wage Issues in the Restaurant Industry*, 30 ABA J. LAB. & EMP. L. 389, 391 (2015).

<sup>29</sup> *Id.* The minimum wage in effect from 1991 through October 1, 1996 was \$4.25 per hour. *See id.* § 206(a)(1); *Kilgore v. Outback Steakhouse of Fla., Inc.*, 160 F.3d 294, 297 (6th Cir. 1998). Thus, employers had to provide \$2.13 in minimum cash compensation to



due tipped employees at “the cash wage required to be paid such an employee on August 20, 1996”,<sup>30</sup> i.e., \$2.13.<sup>31</sup> Thus, current law allows more than 70.6 percent—\$5.12—of the current \$7.25 federal hourly minimum wage to come in the form of tips.<sup>32</sup> The amount of compensation that an employer may provide to a tipped employee in the form of tips and credit toward the employee’s minimum wage is called the “tip credit.”

The FLSA imposes two requirements that an employer must meet in order to take advantage of the tip credit with respect to an employee: first, the employer must advise the employee of its intent to treat tips as satisfying part of the employer’s minimum wage obligation, and, second, it must allow the employee to retain “all tips received by such employee.”<sup>33</sup>

At first blush, one might read the statutory “tip credit” requirement—that the employer must allow the employee to retain “all tips received by such employee”<sup>34</sup>—as foreclosing the possibility of tip pooling where a tip credit is sought. But the statute expressly provides that it “shall not be construed to prohibit the pooling of tips among employees who customarily and regularly receive tips.”<sup>35</sup>

## 2. Restrictions on Tip-Pooling

The Department of Labor and the courts have interpreted the FLSA to allow tip-pooling both as a voluntary matter, and as mandated by employers.<sup>36</sup>

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tipped employees. *See Myers v. Copper Cellar Corp.*, 192 F.3d 546, 548 & n.3 (6th Cir. 1999).

<sup>30</sup> 29 U.S.C. § 203(m).

<sup>31</sup> Susan N. Eisenberg & Jennifer T. Williams, *Evolution of Wage Issues in the Restaurant Industry*, 30 ABA J. LAB. & EMP. L. 389, 392 (2015).

<sup>32</sup> *Id.* The minimum wage in effect from 1991 through October 1, 1996 was \$4.25 per hour. *See id.* § 206(a)(1); *Kilgore v. Outback Steakhouse of Fla., Inc.*, 160 F.3d 294, 297 (6th Cir. 1998). Thus, employers had to provide \$2.13 in minimum cash compensation to tipped employees. *See Myers v. Copper Cellar Corp.*, 192 F.3d 546, 548 & n.3 (6th Cir. 1999).

<sup>33</sup> 29 U.S.C. § 203(m).

<sup>34</sup> *Supra* note 33.

<sup>35</sup> 29 U.S.C. § 203(m).

<sup>36</sup> *See, e.g., Kilgore v. Outback Steakhouse of Fla., Inc.*, 160 F.3d 294, 303-04 (6th Cir. 1998) (concluding that the FLSA “expressly permits the ‘pooling of tips’ and does not bar employers from requiring tip pooling”).

The DOL has taken the position that an employer cannot require employees “to contribute a greater percentage of their tips than is customary and reasonable”; the Division has elucidated that a mandatory tipping pool is “customary and reasonable” if employees retain at least 15% of their tips. 1 LES A. SCHNEIDER & J. LARRY STINE, *WAGE AND HOUR LAW: COMPLIANCE AND PRACTICE* § 7:9. But the court of appeals in *Kilgore* recently rejected this interpretation as supported neither by the language of the statute or regulations. *See* 160 F.3d at 302-03 (finding that the only valid restriction on mandatory

Mandatory tipping pools may extend only to employees “who customarily and regularly receive tips.”<sup>37</sup> There is currently a dispute as whether (i) this bar applies only when employers invoke the tip credit, as some courts have recently held,<sup>38</sup> or (ii) this bar is absolute, as DOL regulations maintain.<sup>39</sup> Tipped employees, it should be noted, enjoy more latitude in crafting voluntary tip pooling arrangements than employers have in mandating them.<sup>40</sup> Federal law leaves states free to impose bars against employer-mandated tip pooling, as we discuss just below.<sup>41</sup>

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tipping pools is that tipped employees’ wages remain at or above the applicable minimum wage).

<sup>37</sup> 29 U.S.C. § 203(m). *Compare Kilgore*, 160 F.3d at 301-02 (holding that restaurant hosts at Outback Steakhouses “work in an occupation that customarily and regularly receives tips,” and in doing so contrasting hosts with “restaurant employees like dishwashers, cooks, or off-hour employees like an overnight janitor who do not directly relate with customers at all”), *with Myers v. Copper Cellar Corp.*, 192 F.3d 546, 550-51 (6th Cir. 1999) (“Because [Copper Cellar ‘salad makers’] abstained from any direct intercourse with diners, worked entirely outside the view of restaurant patrons, and solely performed duties traditionally classified as food preparation or kitchen support work, they could not validly be categorized as “tipped employees” under section 203(m),” and therefore were not improperly included in a mandatory tipping pool.).

<sup>38</sup> *See supra* notes 17-18 and accompanying text.

<sup>39</sup> *See* 29 C.F.R. § 531.52.

<sup>40</sup> *See* SCHNEIDER & STINE, *supra* note 36, § 7:9 (“Despite the[] requirements for involuntary pooling arrangements imposed by [an] employer, employees may enter pooling arrangements with terms which do not conform to these rules if the contributing employees mutually agree to such terms.” (footnote omitted)).

<sup>41</sup> *See Jameson v. Five Fleet Restaurant, Inc.*, 131 Cal. Rptr. 2d 771, 776 (Ct. App. 4th Dist. 2003) (“Because [California law] imposes prohibitions on tip pooling not contained in the FLSA, . . . federal authorities . . . are inapplicable.”); *id.* (“Under [California law], tip pooling is only permitted among employees who are neither employers nor agents.”). Some states have statutes that expressly prohibit employer-mandated tip pooling. *See* Walter John Wessels, *Minimum Wages and Tipped Servers*, 35 ECON. INQUIRY 334, 336 (1997); *see, e.g.,* MINN. STAT. § 177.24(3) (“No employer may require an employee to contribute or share a gratuity received by the employee with the employer or other employees or to contribute any or all of the gratuity to a fund or pool operated for the benefit of the employer or employees. This section does not prevent an employee from voluntarily and individually sharing gratuities with other employees. The agreement to share gratuities must be made by the employees free of any employer participation.”). But that position is hardly uniform. *Compare* Matter of Wage & Hour Violations of Holly, Inn Inc., 386 N.W.2d 385, 310 (Minn. Ct. App. 1986) (Minnesota “statutes indicate that mandatory tip sharing is not allowed.”), *with* Leighton v. Old Heidelberg, Ltd., 268 Cal. Rptr. 647, 649-53 (Ct. App. 2d Dist. 1990) (California law does preclude employer-mandated tip pooling); *Alford v. Harolds Club*, 669 P.2d 721, 723-24 (Nev. 1983) (same result under Nevada law); *Wynn Las Vegas, LLC v. Baldonado*, 311 P.3d 1179 (Nev. Sup. Ct. 2013 (en banc) (Nevada laws employer-mandated tip-pooling where all tips are distributed to employees); *Fraser v. Pears Co.*, 16 Mass. L. Rptr. 255 (Mass. Super. Ct. 2003) (same result under Massachusetts law).

## B. State Law

States are free to supplement the restrictions of the federal law of tip pooling. A few states have opted to ban mandatory tip-pooling altogether,<sup>42</sup> although voluntary tip-sharing remains permissible.<sup>43</sup> Other states allow mandatory tip-pooling, but impose additional restrictions on which workers may be compelled to participate in such arrangements.<sup>44</sup> And some states exclude mandatory service charges from treatment as gratuities.<sup>45</sup>

## II. THE INCENTIVES UNDERLYING TIP-POOLING

We consider restaurant tip-pooling under two circumstances. First, we consider the setting where the servers themselves decide whether or not to engage in tip-pooling. Then we consider the scenario in which management decides to impose tip-pooling. Our discussion centers on the notion that, whether management mandates tip-pooling or not, the provision of services to restaurant customers is—or at least generally should be—a cooperative endeavor among numerous employees.

### A. Voluntary Tip-Pooling

If management does not mandate tip-pooling, then waitstaff enjoy the prerogative to decide whether, and if so with whom and to what extent, to pool tips. In accordance with standard economic assumptions, we assume as a general matter that in making these decisions each waiter or waitress seeks to maximize

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<sup>42</sup> See KY. REV. STAT. § 337.065(1) (“No employer shall require an employee to remit to the employer any gratuity, or any portion thereof, except for the purpose of withholding amounts required by federal or state law.”); *id.* § 337.065(3) (“No employer shall require an employee to participate in a tip pool whereby the employee is required to remit to the pool any gratuity, or any portion thereof, for distribution among employees of the employer.”).

<sup>43</sup> See *id.* § 337.065(4) (“Employees may voluntarily enter into an agreement to divide gratuities among themselves. The employer may inform the employees of the existence of a voluntary pool and the customary tipping arrangements of the employees at the establishment.”).

<sup>44</sup> See CAL. LABOR CODE § 351 (“No employer *or agent* shall collect, take, or receive any gratuity or a part thereof that is paid, given to, or left for an employee by a patron, or deduct any amount from wages due an employee on account of a gratuity, or require an employee to credit the amount, or any part thereof, of a gratuity against and as a part of the wages due the employee from the employer.” (emphasis added)); *Jameson v. Five Feet Restaurant, Inc.*, 107 Cal. App. 4th 138, 143, 131 Cal. Rptr. 771, \_\_\_ (Ct. App. 4th Dist. 2003) (interpreting section 351 to preclude not only “employers” from participating in mandatory tip pools, but also employers’ “agents”).

<sup>45</sup> See *Searle v. Wyndham Int’l, Inc.*, 102 Cal. App. 4th 1327, 1335, 126 Cal. Rptr. 2d 231, \_\_\_ (Ct. App. 4th Dist. 2002) (“Because the service charge is mandatory and because the hotel is free to do with the charge it as it pleases, the service charge is simply not a gratuity which is subject to the discretion of the individual patron.”).

his or her own profits.<sup>46</sup> Under these conditions, we can view waiters and waitresses as a restaurant as private business people independently providing services to restaurant customers. To be sure, the waiters and waitresses do not compete for individual customers as do, for example, competing restaurants.<sup>47</sup> Rather, the waitstaff service the customers who choose to patronize the restaurant at which the waitstaff work. Still, we may view each waitress or waiter as purchasing food from the restaurant kitchen, which she or he then resells to the customers seated at her or his tables. The waitresses and waiters enjoy the profits (in the form of tips),<sup>48</sup> and they must decide how to structure restaurant service so as to maximize those profits.<sup>49</sup>

### 1. Degrees of Cooperation

To begin, the waitstaff must decide how much they will cooperate. Dean Levmore has offered theories as to why firms might, and might not, cooperate with each other under competitive conditions.<sup>50</sup> First, he identifies different degrees of cooperation: explicit cooperation, and varying degrees of implicit cooperation and of non-cooperation; he delineates them in the context of two competing firms that purchase like goods on an ongoing basis.<sup>51</sup> Under the model of explicit cooperation, the two competitors might engage in joint venture-like behavior and agree to own and operate a factory from which they both will purchase output.<sup>52</sup> Implicit cooperation arises if the two firms purchase supplies from the same factory, with neither of the competitors having an ownership or operational interest in the factory.<sup>53</sup> Stronger implicit cooperation exists if the factory supplies goods to both competitors but is owned by one of the competitors.<sup>54</sup> Under strict non-cooperation, firms “may refuse to deal with suppliers who deal at all with competitor firms.”<sup>55</sup> A less strict form of non-cooperation envisions firms that “refuse to deal with suppliers who sell identical components to competitor firms.”<sup>56</sup>

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<sup>46</sup> *But see* Cass R. Sunstein, *Human Behavior and the Law of Work*, 87 VA. L. REV. 205, 207 (2001) (“[W]orkers are like most people. They behave like *homo sapiens*, not like *homo economicus*.” (citation omitted)).

<sup>47</sup> We address the possibility of [using maitre d’] below.

<sup>48</sup> *Cf.* Wessels, *supra* note 41, at 334-35 (“likening tipping to profit sharing”).

<sup>49</sup> We discuss below the question of how waitstaff might choose whether, and the extent to which, to pool tips, *see infra* Part II.A.2.

<sup>50</sup> *See* Saul Levmore, *Competition and Cooperation*, 97 MICH. L. REV. 216 (1998).

<sup>51</sup> *See id.* at 217-18.

<sup>52</sup> *Id.* at 218.

<sup>53</sup> *Id.*

<sup>54</sup> Levmore describes this option as lying between the first two insofar as “[t]he trading between competitors is now explicit although the investment in the factory was implicitly cooperative.” *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

Levmore’s taxonomy of cooperation can be adapted to the setting of restaurants and waitstaff. There is a minimal level of cooperation at a restaurant, insofar as the waiters and waitresses have at a minimum agreed to work at the same restaurant and (viewing each waitress and waiter as an independent operator) to offer the same food prepared by the same chefs. To this extent, then, the waitstaff have agreed to cooperate implicitly. Beyond that, the waitstaff remain free to choose a level of cooperation.

An initial decision is whether the waitstaff will agree to engage in what we refer to as “explicit cooperation”—pooling of tips among all waiters and waitresses. In the economic language of firm structure, this is the decision of whether or not to integrate horizontally. If the waitstaff agree to cooperate explicitly, then a subsidiary decision arises—whether or not further to pool tips with other restaurant workers such as the busstaff. Table 1 reflects these choices.

TABLE 1 – OPTIONS UNDER EXPLICIT COOPERATION

|   |
|---|
| Tip-Pooling Restricted to Waitstaff; Other Services Effectively Purchased from Restaurant |
| Tip-Pooling Extended to Other Staff   |

If the waiters and waitresses decide not to pool tips among one another, then in effect they will be in competition. At this point, they must decide the degree to which they will implicitly cooperate with one another.<sup>57</sup> First, they might decide simply to share (without delineation) the support staff provided by the restaurant. Under this scenario, the waiters and waitresses would not pool tips with other restaurant staff, and would simply use their services as needed.

A second option that reflects less cooperation is to have individual waiters and waitresses entice restaurant support staff to provide more (better or faster) service to them by tipping the support staff as they provide services or at the end of each shift. By this, we do not envision a formal tip-pooling arrangement between waitstaff and support staff; rather, waitresses and waiters would provide tips on an individual basis as they see fit. This notion may be of greater applicability with respect to certain support staff services than others. For example, the notion of a waitress tipping a busboy for prompt service on an individual basis might be difficult in practice, but waiters at some restaurants do indeed tip the individuals manning the beverage or dessert bars for faster service.<sup>58</sup> Under this scenario, the waitstaff are still using services provided by the restaurant, but they are openly competing with one another for priority with respect to those services.

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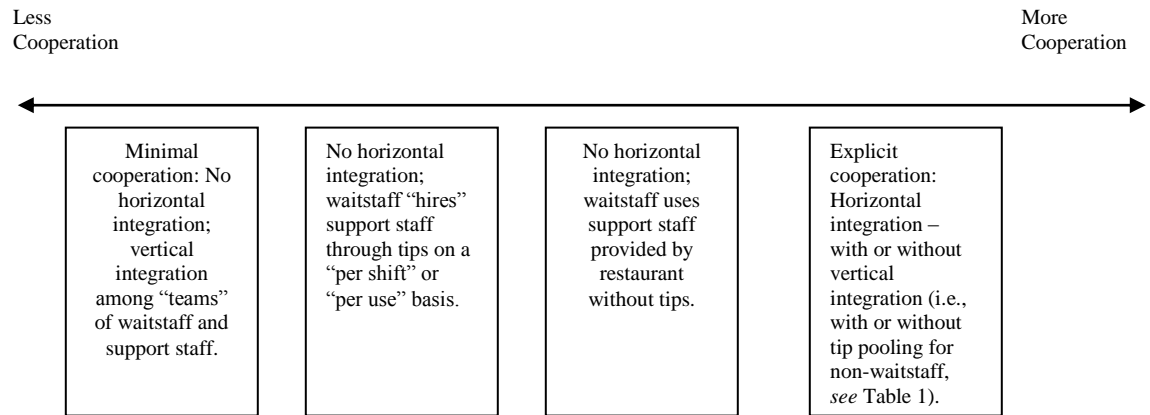
<sup>57</sup> As noted above, there is a minimal level of implicit cooperation, so that non-cooperation is not an option.

<sup>58</sup> Interview with Orin Tempkin (Aug. 3, 2003).

A third option that reflects even less cooperation among the waitstaff is for the servers to join with particular support staff and form “service teams” that share tips. In the economic language of firms, this scenario is a form of vertical integration. For example, each waiter might choose his or her own buserperson; each team of waiter and buserperson would then service only their own customers, and would pool tips obtained from those customers. Under this scenario—minimal cooperation—the waiters and waitresses cooperate with one another only with respect to the provision of foods prepared by the restaurant.

Figure 1 presents the varying degrees of cooperation, and the resulting staff structures.

FIGURE 1 – OPTIONS UNDER VARYING DEGREES OF COOPERATION



There is a full spectrum of cooperation possibilities beyond the four distinct options presented in the figure. For example, under minimal cooperation, it is possible that waiters will offer service to patrons sitting at tables outside their “station” if specifically requested; it is also possible that they will absolutely refuse to service tables outside their station. Similarly, a buserperson who clears off a table may leave the tip on the table if the buserperson was not responsible for the party who left the tip.

## 2. Choosing the Level of Cooperation

Having set out possible degrees of cooperation in which waitstaff might engage, we turn to the question of how waitstaff will choose a level of cooperation.

As an initial matter, we think that, once a system (of tip-pooling or no tip-pooling) is in place, that system is likely to remain in place. It seems likely to us that a particular arrangement will over time become settled at an existing

establishment, and will (whether for reasons of inertia or otherwise) likely simply be accepted by new hires. But change is possible for several reasons.

First, there is the possibility that management-mandated tip-pooling might make voluntary tip-pooling more likely. To the extent that management is permitted by law to mandate tip-pooling, the shadow of management compulsion may convince waitstaff simply to come up with an agreement on their own, which they may prefer to whatever arrangement management might require.

Second, it may be in the economic self-interest of waiters and waitresses to engage in some tip-pooling entirely on their own. For example, waitstaff might believe that tip-pooling would lead to uniformly better service, which would in turn lead to increased patronage and increased tipping, such that all (or virtually all) members of the waitstaff would receive higher pay under a tip-pooling regime.

Third, tip-pooling also addresses employee concerns over horizontal equity – whether similarly-situated employees are being compensated in a relatively uniform manner. Employees tend to evaluate their satisfaction with their compensation based more upon how their salaries match up with other workers' salaries, than on their salaries' absolute magnitude.<sup>59</sup> Tip-pooling helps ensure that the happenstance of directly serving the customer does not determine significant differences in compensation, that all employees who engage in the joint venture of serving customers are comparably compensated for the contribution they make to the joint product. Tip-pooling involve a shift of resources to waitstaff to the kitchen personnel may also provide compensation for differential status that otherwise might hamper cooperation.

In addition, our earlier premise that waiters and waitresses might view themselves as independent competitors is likely to be accurate in relatively few settings. Many waiters and waitresses are more likely to view themselves as allies in a joint undertaking. To that extent, the assumption that tip pooling will occur only where waiters and waitresses see it to be in their individual self-interest is overstated.

## B. Mandatory Tip-Pooling

As we noted above, federal law and the law of many (if not most) states authorize restaurant management to impose at least some degree of tip pooling on restaurant workers. In this part of the Essay, we explore the circumstances under which management is likely to exercise that authority.

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<sup>59</sup> See, e.g., Robert H. Frank & Cass R. Sunstein, *Cost-Benefit Analysis and Relative Position*, 68 U. CHI. L. REV. 323 (2001).

At the outset, we assume, as before, that economic self-interest dominates. Accordingly, we assume that management is concerned in some way with maximizing restaurant profits.<sup>60</sup> That means that management will implement tip-pooling where such an arrangement will lead to an increase in restaurant profits. It may seem somewhat odd to some that management would need to introduce market-like economic incentives *within* a firm. But the fact remains that restaurant employees are engaged in an endeavor that works best under cooperative among waitstaff, and the employer may wish to introduce incentives to ensure that cooperation indeed occurs.

The time horizon over which profits are to be maximized and the type of restaurant will affect the decision management makes. For example, management may simply want to maximize customer turnover so as to increase short-term profits. In that case, management's choice as to tip-pooling will turn on whether the resulting service structure will generate quicker turnover.

Management may also be concerned with the perceived quality of service, insofar as they affects repeat business, and profits over the longer term. Management may conclude that service is kinder and friendlier in a setting where servers get along well, and may determine that tip pooling fosters that goal. Certainly, in cases where destructive competitive tipping—that is, tipping that is designed to encourage service providers to provide service to higher tippers to the exclusion of lower tippers<sup>61</sup>—is interfering with proper service, management may find it especially appropriate to impose tip-pooling.

Management also may be seeking to maximize profits by minimizing cash salary payments to staff. Recall that tips can be used to offset the cash minimum wage that management must pay to workers. Thus, if a restaurant pays more of its workers at below the generally applicable minimum wage, it may invoke tip pooling as a means of distributing tips over a greater set of employees.

Management's business plan may also rely on retaining employees over the long term. One aspect of that strategy might be a focus on increasing the attractiveness of lower-tier positions. Tip-pooling provides a mechanism for some improvement in compensation from relatively higher-paid tipped employees to relatively lower-paid non-tipped employees.<sup>62</sup>

As in the case of voluntary tip-pooling, sometimes concerns that are not strictly economic might influence management's decision to establish mandatory tip-pooling, such as a desire to promote horizontal equity among similarly-

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<sup>60</sup> If management and ownership are identical, then the incentive is clear. If management is distinct from ownership, then presumably ownership will reward management for increases in profits, and thus profit-maximization is incentivized.

<sup>61</sup> See Saul Levmore, *Norms as Supplements*, 86 VA. L. REV. 1989, 1994 n.7 (2000).

<sup>62</sup> It may also have a redistributive effect favoring higher-paid employees if some managerial employees are, contrary to federal law, permitted to participate in the pool.



situated employees. On the other hand, management might be less inclined to implement tip-pooling where waitstaff have been at the position for a considerable period of time; mandating tip-pooling in such circumstances may upset entrenched expectations as to compensation. Moreover, any increase in income to waitstaff from mandatory tip-pooling in such circumstances is not likely to be significant given the likelihood of some degree of voluntary sharing in the absence of the mandate.

### III. THE MISMATCH BETWEEN TIPPING BANS AND THE OBJECTIVE OF MINIMIZING RESTRICTIONS ON TIP-POOLING

If the object of a ban on tipping is to shift compensation from relatively higher-paid tipped employees to the relatively lower-paid “back-of-the-restaurant” staff, the ban is likely to be less direct, less efficient in promoting the stated objective than a relaxation of existing legal constraints on tip-sharing

#### A. Eliminating Tipping to Approximate Broader Tip-Pooling

As discussed earlier, some restaurants may be considering banning tipping as a means of shifting income from front-of-the-house waitstaff to back-of-the-house employees. This is doubtful way to promote a more egalitarian distribution of tip income among employees. If tipping is banned, there is no tip-pooling; there is only management determination of compensation.

#### B. Danny’s Disequilibrium

We are sympathetic to the frustration of restaurants that are unable, because of legal impediment, include back-of-the-house employees in tip pools. At the same time, USHG’s response is a distant second to the far preferable response of legal reform. We propose prudent legal reform that responds to the existing problem in the next Part. Here, we elucidate problems with USHG’s existing response.

First, the elimination of tipping is at counter-purposes with management’s objective to promote quality service to customers.<sup>63</sup> The institution of tipping helps to solve a massive principal-agent problem. The principal (management) is in a poor position to monitor the provision of services to customers; that, in turn, invites agents (employees) to shirk in their provision of services. Tipping helps to solve the principal-agent problem, by empowering customers—who *can* monitor the provision of services—to reward good service. The elimination of tipping restores restaurateurs’ principal-agent problem.

Second, we believe that USHG’s response is not tenable. As just discussed, the elimination of tipping presents a substantial principal-agent problem. Unsolved, it is likely to lead to customers having to endure worse service than at the establishment of competitors who retain tipping. Additionally, it is debatable whether customers—who are used to having the freedom to tip in order to induce better service—will agree to pay higher prices for food without the ability to compensate for service.

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<sup>63</sup> Professor Margalioth, *supra* note 22, at 580, questions whether tipping *vel non* affects quality of service. We agree that the average size of tips is more a function of the size of the bill than anything else. But we believe the presence of tipping raises the level of quality; that, for example, in countries where tipping is not customary, such as France, the quality of service is considerably lower than expectations in the U.S.

In economic terms, USHG's response is not a viable equilibrium. Only if many competitors also follow USHG's lead could the USHG response be a viable equilibrium,<sup>64</sup> and we strongly suspect that competitive pressures will dissuade others from following suit.

#### **IV. THE PROBLEMATIC OF MOST RESTRICTIONS ON TIP-POOLING**

Existing law puts severe limits on tip-pooling. Management-level employees may not participate in tip-pooling. Back-of-the-house employees are ineligible to participate in employer-mandated tip-pooling. And States are free under federal law to bar employer-mandated tip-pooling altogether. We agree only with the first of these restrictions. While management-level employees should indeed be barred from tip-pooling arrangements, employers should generally be free to mandate tip pools, and to include back-of-the-house employees from participating in those pools.

Consider initially that the delivery of services in the context we are considering is a cooperative endeavor. No single employee can provide service, let alone ensure that the service provided is quality service. Yet, while customers are relatively well-positioned to monitor front-of-the-house employees, they are not in a position to monitor back-of-the-house employees; after all, customers rarely come in contact with back-of-the-house employees, or to observe clearly the quality of the services they render. But front-of-the-house employees are well positioned to monitor the quality that back-of-the-house employees render.

The foregoing provides a sound basis for front-of-the-house employees voluntarily to enter to tip-pooling arrangements that include back-of-the-house employees. But our argument here goes farther: We posit that owners ought to have the power to mandate such arrangements. We offer four justifications for this conclusion.

First, employees are often not well-positioned to decide upon, and to implement, tip-pooling arrangements. Even employees who might otherwise be inclined face strong inertial forces without the coordinating role of management. Moreover, any tendency by employees acting on their own to favor certain employees over others in the tip pool would create friction among employees that undermines the enterprise as a whole.<sup>65</sup> Management, because it is responsible for the welfare of the enterprise as a whole, is likely to avoid such strains.

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<sup>64</sup> See Hollander, *supra* note 9 (“If a restaurant menu item is priced 25% to 30% higher than a competitor’s, one would imagine the restaurant is at a competitive disadvantage,” said Andrew Rigie, director of the New York City Hospitality Alliance . . .”).

<sup>65</sup> See, e.g., *Leighton v. Old Heidelberg, Ltd.*, 269 Cal. Rptr. 647, 653 (Ct. App. 2d Dist. 1990).

Second, owners have put their capital at risk. As such, it makes sense to empower them to create incentives in order to generate the cooperative arrangements that they believe will enhance their profits.

Third, limits on tip-pooling restrict management's ability to attract and retain the best employees<sup>66</sup>

We are especially dubious of the Department of Labor's assertion that the FLSA's limitations on mandatory tip-pooling apply even if the employer does not seek to benefit from the tip credit. Employees who are subject to the tip credit earn less than the ordinary minimum wage in direct compensation; insofar as they rely on tips to bring their income up to the standard minimum wage, some restrictions on tip-pooling make at least some sense in that setting. However, we question just how common it is for waitstaff to be paid (if tips are included) so close to the minimum wage that restaurants invoke the tip credit. Indeed, there is evidence that the restaurant industry is highly competitive.<sup>67</sup> If that is so, then imposing restrictions on tip-pooling where the tip credit is invoked may be warranted, but imposing those restrictions where the tip credit is not invoked require reexamination.

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<sup>66</sup> See *id.* (“To permit a waitress to determine what if anything she should share with the busboy based upon what she deems to be the worth of his service can only lead to the . . . loss of good employees . . . and a disruption in the kind of service the public has a right to expect. An employer must be able to exercise control over his business to . . . provide good service to the public.”); Wells, *supra* note 9 (noting that a USHG chef “has been agitating for higher pay to attract skilled cooks”); Gordinier, *supra* note 10 (noting that a USHG restaurant’s executive chef “is enthusiastic about the change because it means he will be able to pay his cooks something closer to a living wage, and retain talent”); Alexander, *supra* note 13 (noting that the decision by Danny Meyer to increase menu prices by 20% “means [that] he is now able to pay his chefs a better salary and [he] has already seen a spike in applications from talented cooks”).

<sup>67</sup> See John E. Anderson & Örn B. Bodvarsson, *Do Higher Tipped Wages Boost Server Pay?*, 12 APPLIED ECON. LETTERS 391 (2005) (finding little evidence of a premium to servers in states with more generous minimum wages); Alex Tabarrok, *The Problem of Contingent Fees for Waiters*, <https://mason.gmu.edu/~atabarro/ContingentFeesforWaiters.pdf> (arguing that, even though the tip percentage does not vary with meal price, the fact that the total tip amount does vary with the meal price strongly suggests that the market for servers is highly competitive); *but see* National Employment Law Project, *Minimum Wage Basics: Overview of the Tipped Minimum Wage* (Apr. 2015) (data showing that many workers, and in particular many servers, earn less than the standard minimum wage in direct employer compensation); *see also* Donald G. Schmitt, *Tips: The Mainstay of Many Hotel Workers’ Pay*, MONTHLY LABOR REV., July 1985, at 50 (data showing that extent to which tip income constitute total wages varies by industry).

**CONCLUSION**

Tip-pooling promotes the objectives of ownership – it is a form of variable pay,<sup>68</sup> compensating employees according to the quality of their services. It is also a form of profit-sharing -- both in the sense that employees share tips among themselves and in the sense that tipping allows workers to share (if indirectly) in a restaurant's profits. We believe that the law should not generally restrict this hybrid form of compensation, other than to make sure that owners are not diverting tips to themselves and that tipped employees are at least paid the statutory minimum wage once tips are counted.

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<sup>68</sup> See MARTIN L. WEITZMAN, *THE SHARE ECONOMY: CONQUERING STAGFLATION* (1984) (arguing that stagflation results in large measure from the predominance of the fixed-wage labor contract).