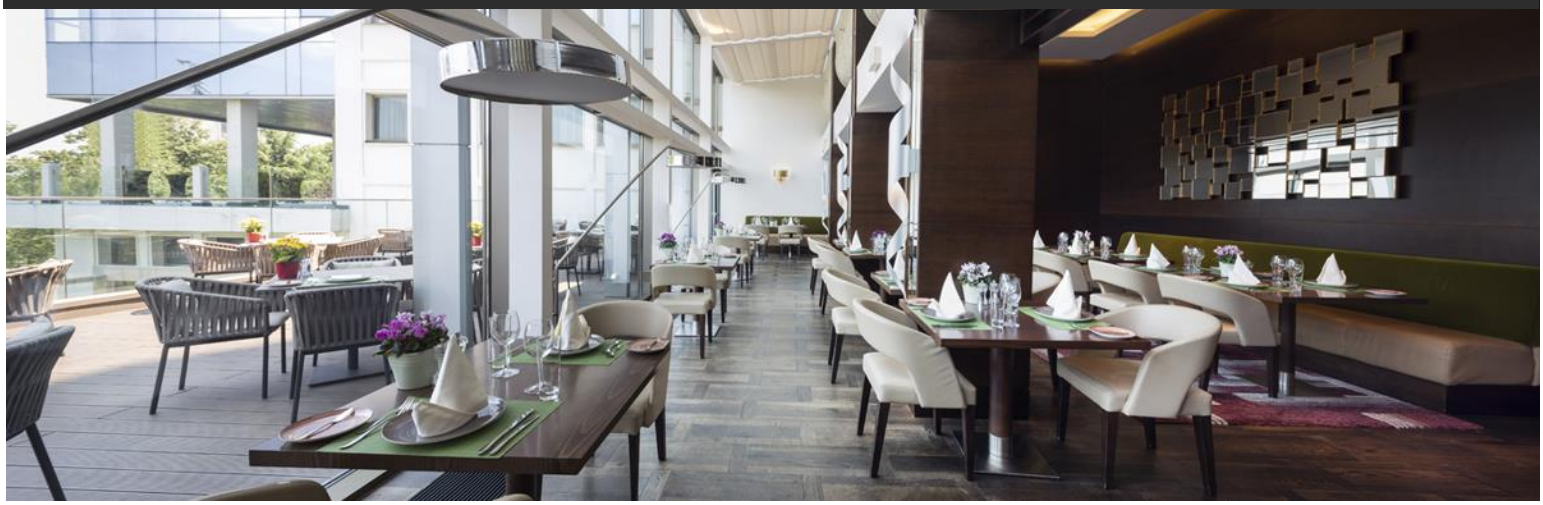
GT GreenbergTraurig

Alert | Restaurant Industry / California Government Law & Policy



May 2024

SB 478 May Require Significant Shifts in Pricing Practices for California Restaurants

Go-To Guide:

- DOJ interpretation of SB 478 may impact long-established and common restaurant business practices
- Consequences of noncompliance are potentially significant
- Law goes into effect July 1, 2024
- Click here for a matrix summarizing various fees and surcharges in the context of the DOJ's FAQ.

Introduction: The California Department of Justice's May 8, 2024 FAQ

On May 8, 2024, the California Department of Justice (DOJ), issued a much-anticipated FAQ (the FAQ) on a new amendment to California's Consumer Legal Remedies Act (CLRA). Although the FAQ addresses the DOJ's interpretation of Senate Bill 478 (SB 478) to various restaurant pricing practices, it leaves many questions unanswered. The FAQ is not binding law. Even so, the FAQ represents the DOJ's current interpretation and signals how the law may be enforced with respect to certain restaurant pricing practices. Thus, the FAQ is a useful guide for compliance and risk assessments, and it may guide arguments by county and municipal prosecutors, as well as the plaintiffs' bar.

Existing law suggests that the CLRA may not apply to dine-in restaurant offerings, and that menus may not qualify as "advertising" under the statute. Thus, SBA 478's applicability to restaurant pricing practices is expected to be hotly contested, and the restaurant industry can anticipate increased litigation on this topic.

The Background: The CLRA Amendment

A new amendment to a California consumer protection statute—the CLRA (Cal. Civ. Code § 1770)—goes into effect July 1, 2024. The statute requires businesses to include certain fees that have become ubiquitous in the restaurant, food delivery, and hospitality industries into the advertised price of such goods or services. The law applies to almost any sale (or lease) of most goods or services that are for a consumer's personal—but not commercial—use. As explained below, noncompliance creates potentially significant risk of damages, statutory penalties, attorneys' fees, and other relief through government enforcement and private class action litigation.

Pricing Transparency Is the Primary Purpose

The stated goal of SB 478 is to promote price transparency and protect consumers from misleading advertising practices, like "drip pricing," "junk" fees, and other bait-and-switch strategies. In general, the statute prohibits sellers from attracting a customer through a low item/headline price, and then disclosing additional mandatory fees or revealing unavoidable charges later in the buying process—like the final bill or checkout screen.

Pricing to Include all 'Mandatory' Fees or Charges

SB 478 makes it unlawful for businesses to advertise or list a price for a good or service that does not include all "mandatory" fees or charges. The only statutory exceptions are narrow: (i) certain government taxes, and (ii) shipping costs—i.e., "postage or carriage charges that will be reasonably and actually incurred to ship the physical good to the consumer." The amendment does not impact how businesses determine their prices (e.g., algorithmic or dynamic pricing) or what they include. As explained in the FAQ, "A business is generally free to charge whatever amount it wants for a good or service, to provide a subsequent breakdown of the various fees or charges that are included in its listed or advertised price, and to tell the consumer about those fees and charges. But the posted price must include all amounts that the consumer will be required to pay."

The statute mandates price transparency by adding the following provision to the CLRA:

> 1770. (a) The unfair methods of competition and unfair or deceptive acts or practices listed in this subdivision undertaken by any person in a transaction intended to result or that results in the sale or lease of goods or services to any consumer are unlawful:
>
> * * *
>
> (29) (A) Advertising, displaying, or offering a price for a good or service that does not include all mandatory fees or charges other than either of the following:
>
> (i) Taxes or fees imposed by a government on the transaction.
>
> (ii) Postage or carriage charges that will be reasonably and actually incurred to ship the physical good to the consumer.

Applying SB 478 to Restaurants: Key Takeaways from the May 8 FAQ

As noted above, the FAQ is not binding law, and litigation on the application of the CLRA to restaurants is expected to continue. However, the FAQ does provide a window into the DOJ's view of the law, and is the first and only substantive communication from the DOJ discussing SB 478's potential application to restaurants. Restaurants may benefit from becoming familiar with the FAQ and seeking legal advice.

Adding Separate Mandatory Surcharges Is Potentially Unlawful in California as of July 1, 2024

From the DOJ's perspective in the FAQ, SB 478 signals a potential shift in mandatory surcharge pricing practices for many California restaurant operators. For more than a decade, California restaurants have used various separate line-item mandatory surcharges (i.e., a "3% fee to cover minimum wage increases"), largely to cover or to help mitigate the impact of increased costs and as an alternative to raising menu prices. Generally, these surcharges were permissible so long as they were conspicuously disclosed to the customer before purchase.

According to the FAQ, after July 1, California restaurants must include mandatory surcharges in the advertised price of menu items. Although California restaurants are free to set prices (and include in such prices the costs and fees that they wish to pass along to customers), the FAQ advises that such mandatory charges, costs, or fees need to be included in the advertised price of the menu item(s).

Menu Price Increases Are Alternatives to Mandatory Surcharges

Restaurants may seek to mitigate their risk in response to the FAQ. If they wish to pass along cost increases or charge mandatory fees to customers, restaurants may consider raising menu prices. The FAQ invites businesses to explain to customers that certain fees or charges are included in the advertised price but advises that restaurants include such fees or charges in the advertised price of menu items.

For example, a restaurant that currently charges a mandatory separate 5% fee to cover increased labor costs faces potential exposure under the DOJ's interpretation set forth in the FAQ. However, as set forth in the FAQ, the restaurant can increase menu prices by 5% and explain to customers that the 5% increase is due to rising labor costs.

In some cases, restaurants may benefit from disclosing reasons for price increases to customers. For example, restaurants that contribute a percentage of the purchase price toward employee health care costs may find value in making customers aware of this. On the other hand, restaurants that use surcharges solely to maintain/increase profitability as an alternative to raising menu prices may not wish to make such disclosure.

Menu Prices Need Not Include Delivery Services Fees

According to the FAQ, restaurants may still lawfully charge separate fees for food delivery services. The FAQ advises that "fees for the delivery of food ordered directly from a restaurant ***do not need to be included in the advertised price of the food or other items ordered because those fees are for the separate service of delivery***" (emphasis added). The FAQ does not distinguish between self-delivery and third-party delivery fees. However, the FAQ notes that the delivery fee must be the "***full, all-in price of the delivery service***" (emphasis added).

Questions the DOJ Does Not Address

Must Listed Price Include Mandatory and Automatic Gratuities–Will a 'Safe Harbor' or Exemption Be Created?

Some California restaurants currently use mandatory and automatic gratuities. This is a long-established and typically uncontroversial practice that restaurants utilize in a variety of scenarios, including when parties exceed a certain number of guests, special events, and catering. In addition, many restaurants adopt a "hospitality included" model that includes a separate mandatory service charge in lieu of tipping.

According to the FAQ "***[g]ratuity payments that are not voluntary must be included in the list price***" (emphasis added). This expansive interpretation of mandatory gratuities may mean that, in order to comply with SB 478, a restaurant must include any mandatory or automatic gratuity it charges in the advertised price. Clarification is needed.

This potential new requirement would create several important considerations for California restaurants. A restaurant may be able to avoid building such gratuities into the menu price by making them truly optional, as opposed to mandatory, and clearly identifying the separate service delivered for the added fee. However, optional gratuities, especially in connection with large parties and special events, create uncertainty for tipped workers who may rely on the predictability of such gratuities. Thus, many restaurants may choose to build such gratuities into pricing and disclose to customers the portion of such price being paid to employees as a gratuity. As a practical matter, restaurants utilizing both optional and mandatory gratuities (i.e., optional for smaller parties and mandatory for larger parties and special events) may need separate menus, with one that reflects the "all in" price.

The FAQ notes, "We [the DOJ] do[es] not expect that our initial enforcement efforts will focus on existing fees that are paid directly and entirely by a restaurant to its workers, such as an automatic gratuity. However, ***businesses may be liable in private actions***" (emphasis added).

The DOJ statement that it will not focus initial enforcement efforts on mandatory and automatic tips provides little solace for restaurant operators. The DOJ may eventually elect to make its interpretation of mandatory gratuities a focus of its enforcement efforts. And as the FAQ specifically notes, the risk of private litigation remains.

Mandatory Gratuities and Surcharges Serve Different Purposes

Mandatory and automatic gratuities do not present the same pricing transparency issues and considerations that led to the creation of SB 478. Gratuities are payments that go directly to restaurant employees and are not used by restaurants as an alternative to raising menu prices. Instead, they are used to provide some level of predictability in employee compensation, in addition to reducing tipping confusion with large parties, special events, and catering, where guests or sponsors may not know what to tip or whether to tip at all. An exemption or "safe harbor" for mandatory/automatic gratuities where 100% of such charges go directly to restaurant employees is a topic for additional DOJ consideration. For now, such mandatory charges carry risk.

Will 'Quasi-Optional' Surcharges Be Deemed Unlawful?

In addition, the FAQ provides operators no direction on "quasi-optional surcharges." "Quasi-optional" surcharges are those added as separate line items to the guest's bill, but that the guest has the option to remove. For example, a restaurant bill is presented to the customer on a digital screen and shows a separate 3% surcharge, in addition to the price of food and beverages (and the surcharge is not included in the menu price). The bill reflects both the price of the surcharge and the price of food and beverages the customer orders. The customer is provided the option of having the entire surcharge removed on the tablet screen. Is such a surcharge mandatory or optional? The FAQ does not provide guidance on this type of surcharge. Operators who continue to use "quasi-optional" surcharges will continue to face risk absent clarity.

Will SB 478 Apply to Technology Fees, Reservation Fees, Cancellation Fees, Surge Pricing, Increased Pricing for Delivery v. In-Store Pricing, and Other Pricing Practices?

The FAQ does not directly address a variety of pricing practices and fee structures, warranting clarity from the DOJ. For example, some restaurants add separate "technology" fees to online orders to cover the direct cost of various technology services. Like delivery fees, these are fees that help to cover services, often services third parties provide. The DOJ has approved the exclusion of fees for delivery services from the "listed price" but has not clarified whether it believes technology and other fees can be excluded from this requirement (especially if 100% of such fees are paid directly to third parties). Unless the statute is amended or the DOJ provides additional guidance, such fees carry a litigation risk because they are arguably mandatory for anyone wishing to place an order.

Click here for a matrix summarizing various fees and surcharges in the context of the DOJ's FAQ.

Considerations for Franchisors/Franchisees

It has become common practice for franchisees to pass along various surcharges to consumers to help offset higher food and labor costs, as well as other transaction fees. Franchisees that currently utilize mandatory surcharges (including mandatory and automatic gratuities) should understand that according to the FAQ such charges must be included in the "list price" as of July 1, 2024. Although SB 478 is only one of several newly enacted state laws impacting franchisors and franchisees, franchisors with franchisees operating in California should make their franchisees aware of SB 478 and the risks and consequences associated with noncompliance. Such risks include those discussed below, and also the risk of potential harm to the franchisor's brand and the breach of the underlying franchise agreement (assuming such agreement contains provisions requiring franchisee compliance with applicable law). Franchisors should be careful not to summarize the bill for franchisees or provide direct guidance to franchisees on how to comply with SB 478 because it could inadvertently result in liability. However, franchisors can suggest that California franchisees consult with independent counsel and direct franchisees to the DOJ's website for more information on SB 478 and its potential impact on their businesses.

The Monetary Risks of Noncompliance

The CLRA allows a broad range of remedies in litigation: actual damages (which must be at least $1,000 in class actions), restitution, punitive damages, injunctive relief, and attorneys' fees. (*See* Cal. Civ. Code § 1780.) Senior citizens and disabled persons can obtain an additional $5,000 if specific statutory requirements are met. (*See* Cal. Civ. Code § 1780(b).)

With governmental enforcement, public prosecutors have latitude under the CLRA and statutes like the Unfair Competition Law. (Bus. Prof. C. §§ 17200, *et seq*.) Thus, businesses also should be wary of civil

penalties (which can be as high as $2,500 per violation) and disgorgement (which is now available under recent amendments to the Government Code). (*See* Cal. Bus. & Prof. Code § 17206; Gov. Code § 12527.6.)

In challenging liability and monetary remedies, businesses often argue that there is no damage when a fee is plainly disclosed and knowingly paid, and also that the value of the good/service must be reduced from any adverse award. SB 478 may not impact those arguments, but exposure under the CLRA remains a concern.

Risks of Consumer Class Actions

The plaintiffs' bar is well-positioned to leverage SB 478 in consumer class actions. Until now, hidden-fee cases were subject to the voluntary payment doctrine and similar defenses, arguing that customers have no claim if they were given complete, accurate information before knowingly making a purchase, placing an order, or paying their bill.

But under SB 478, many common business practices may now be *per se* violations of the law. Thus, the plaintiffs' bar may assert claims that a particular fee (other than delivery or shipping) is improper because it is "mandatory"—i.e., not reasonably and meaningfully "optional" or separate from the good/service being purchased—and must be included in the item's price. What's more, the AG's office has taken the position that these fees were already illegal under existing law, and that SB 478 merely confirms existing prohibitions.

Thus, beginning in July, businesses may receive pre-suit demand letters and lawsuits alleging violations of this new amendment to the CLRA and using SB 478 as a springboard for claims under California's other consumer-protection statutes—the Unfair Competition Law and False Advertising Law. (Bus. Prof. C. §§ 17200, *et seq*., and 17500, *et seq*.) In articulating these claims, plaintiffs' attorneys may capitalize on broad guidelines issued by the AG's office that, for reasons discussed above, businesses may find do not consider practical business realities.

Additional Considerations and the Federal Trade Commission's Pending Rule

On Nov. 8, 2023, the Federal Trade Commission (FTC) published a Proposed Rule on Unfair or Deceptive Fees (Proposed Rule). If adopted, it would prohibit covered entities from "misrepresenting the total costs of goods and services by omitting mandatory fees from advertised prices and misrepresenting the nature and purpose of fees." Moreover, any business would be prohibited from offering, displaying, or advertising "an amount a consumer may pay without Clearly and Conspicuously disclosing the Total Price."

The Proposed Rule's application to the restaurant industry would be similar to the California law, requiring menu item prices to include mandatory service fees. The FTC can assess monetary penalties against noncompliant parties, although the exact penalty structure is unknown until the rule is finalized, which will likely be prior to the November presidential election.

Independent of the FTC's Proposed Rule, restaurants have an obligation to comply with SB 478 effective July 1, 2024. Restaurants should carefully review their business practices to ensure compliance with the new law by this date.

Further information is available through the California AG's website. FAQs are expected to be updated as new compliance questions are submitted and answered.

Authors

This GT Alert was prepared by:

- Alan R. Greenfield | +1 312.456.6586 | Alan.Greenfield@gtlaw.com
- Alice L. Kessler | +1 916.868.0605 | kesslera@gtlaw.com
- Adil M. Khan | +1 310.586.3882 | Adil.Khan@gtlaw.com
- Riley Lagesen | +1 503.200.6201 | Riley.Lagesen@gtlaw.com
- Magaly Zagal | +1 916.504.1667 | Magaly.Zagal@gtlaw.com